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THE ROLE FOR DISCRETIONARY FISCAL POLICY
IN A LOW INTEREST RATE ENVIRONMENT

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ABSTRACT

Although there is now widespread agreement in the economics profession that discretionary “counter-cyclical” fiscal policy has not contributed to economic stability and may have actually been destabilizing at particular times in the past, there is one important condition when discretionary fiscal policy can play a constructive role: in a sustained downturn when aggregate demand and interest rates are low and when prices are falling or may soon be falling.

This short note begins by summarizing the general case against using fiscal policy for stabilization. It next considers the argument for using a “hyperexpansive” monetary policy to reduce the risk that a low rate of inflation will lead to a deflationary situation in which monetary policy becomes ineffective. Such a policy would increase the risk of asset price bubbles and of a misaligned exchange rate.

Discretionary fiscal policy provides an alternative way to stimulate the economy when aggregate demand and interest rates are low and when prices are falling or may soon be falling. A stimulus can be achieved without increasing budget deficits if the fiscal policy acts by providing an incentive for increased private spending. Specific examples for the U.S. and Japan are considered.

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The Role for Discretionary Fiscal Policy in a Low Interest Rate Environment

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There is now widespread agreement in the economics profession that deliberate “countercyclical” discretionary fiscal policy has not contributed to economic stability and may have actually been destabilizing at particular times in the past.¹ Most economists agree that monetary policy is the superior tool for macroeconomic stabilization.²

Despite this general presumption against discretionary fiscal policy as a tool of stabilization (which I support), I believe that there is one important condition when discretionary fiscal policy can play a constructive role: in a sustained downturn when aggregate demand and interest rates are low and when prices are falling or may soon be falling. This situation is of more than theoretical interest since it describes Japan’s current condition and some analysts believe may also be relevant to the U.S. and to Germany.

*Professor of Economics, Harvard University, and President of the National Bureau of Economic Research. This note is based on my comments on Alan Auerbach’s paper, “Is There a Role for Discretionary Fiscal Policy?”, presented at the Jackson Hole Federal Reserve Conference, August 30, 2002. Those comments are available at www.nber.org/feldstein/auerbach2002.html

¹I distinguish between “deliberate” discretionary stabilization policy (i.e., aimed at cyclical stabilization) and the incidental effect of fiscal changes done for other reasons. The tax cuts enacted in 1981 and in 2001 were both planned during the earlier election campaigns as structural changes designed to improve long-term incentives but happened to play a positive but unintended stabilization role.

²See for example recent papers by Auerbach (2002) , Giovazzi et. al. (2000) , and Romer and Romer (1994) This view has developed over a long period of time. Even economists who did not consider themselves to be monetarists came to this conclusion on the basis of their own studies. Research by Otto Eckstein in the 1970s and by the Office of Management and Budget of the Carter administration concluded that the timing of previous discretionary fiscal policies had actually been destabilizing.

In discussing the case for discretionary fiscal policy in this context I will also emphasize that an expansionary fiscal policy need not increase the full employment deficit. More specifically, changes in fiscal incentives may be more useful than traditional fiscal policies that increase budget deficits and work through income effects alone.

The Case Against Discretionary Fiscal Stabilization Policy

To explain why discretionary fiscal policy may be constructive in the special case that I have identified, it is useful to begin by reviewing the now generally accepted case against using discretionary fiscal stabilization policy under most circumstances when a change in aggregate demand is desired.

This general consensus against discretionary fiscal policy is a really remarkable reversal from the Keynesian view of appropriate policy that prevailed in the 1960s and even in the 1970s. The basic view at that time was that a shortfall of aggregate demand could be and should be reversed by a cut in taxes or an increase in government spending. The economics profession has now rejected that prescription for three basic reasons:

First, the powerful multiplier effect assumed in the early textbook Keynesian models was dramatically reduced when economists recognized that the marginal propensity to save out of temporary tax cuts is likely to be relatively high and that the increase in money demand that accompanies an economic expansion causes a demand-reducing rise in interest rates.

Second, more recent analyses summarized in Giavazzi et. al., (2000) have shown that tax reductions or expenditure increases can actually depress economic activity. One important way in which this can occur is by raising long term interest rates as bond investors react to the fear of

future deficits. This impact on long-term interest rates is different from the IS-LM model of the effect of money demand on short term interest rates. A very small current budget deficit may have little contemporaneous direct effect on demand but might cause such a large increase in the expected future deficit, and therefore in the long term interest rate, that current demand actually falls, lowering the short-term interest rate. This possibility of the changing shape of the yield curve reconciles the “new” view that a budget deficit can reduce demand through higher interest rates with the traditional IS-LM analysis.³

Third, the combination of fiscal policy lags (recognition lags, implementation lags, and lags in the effect of spending and taxes on aggregate demand) and the substantial uncertainty about the magnitude of the economic response to fiscal changes increases the risk that well-intentioned fiscal policy will be destabilizing, a point emphasized many years ago by Milton Friedman (1953). With the average recession lasting just 11 months from peak to trough, it takes remarkably good luck to add fiscal stimulus at just the right time.

Reacting to the low fiscal multiplier by a more vigorous fiscal policy, i.e., a larger tax cut or spending increase, has two unsatisfactory effects. First, it would leave the economy with a permanently larger national debt. Although early Keynesians dismissed the burden of the debt with the argument that “we only owe it to ourselves,” James Meade later taught us that even a

³ Elmendorf and Reifschneider (2002) show that this effect can be quantitatively important although in the empirical rational-expectations model that they examine it is not important enough to make a fiscal “stimulus” contractionary. The actual effect depends of course on the extent to which market participants extrapolate current deficit increases into the future. Evidence of the positive effect of expected future deficits on long-term interest rates is presented in a recent paper by Canzonieri et. al. (2002).

domestically held national debt is a burden because of the deadweight loss associated with the taxes needed to pay the interest on the debt. Second, the larger is the fiscal policy change, the more likely it is to destabilize total aggregate demand by adding (or subtracting) a large stimulus that is imperfectly correlated with the underlying shortfall (or excess) of demand.

Monetary policy is therefore generally regarded as the policy of choice when it comes to reducing aggregate demand or stimulating a weak economy.

Monetary Policies to Counter Deflation

But what can be done in an economy in which the existing level of demand may cause low inflation to become deflation despite low existing interest rates or in which prices are already falling despite very low interest rates? ⁴

A widely cited Federal Reserve staff study by Ahearne et. al. (2002) points to the Japanese experience in the 1990s and suggests that when inflation is very low and demand is weak monetary policy should be pursued very aggressively, going beyond the interest rate cuts that would normally seem appropriate for that combination of inflation and unemployment⁵.

⁴There is of course no problem with low interest rates and low inflation or even deflation if there is also a healthy positive rate of growth. There is no reason in theory why such a combination is not possible or even, as Milton Friedman (1969) argued, preferable. Although his argument ignored the revenue consequences of negative inflation in an economy in which the taxation of capital income is not indexed for inflation, a more complete analysis might still imply that the optimal inflation rate is negative. My own analysis of the benefits of price stability (Feldstein, 1998, 1999) assessed the effect of reducing true inflation from 2 percent to zero (i.e., reducing measured inflation from about 4 percent to 2 percent) but did not derive an optimal inflation rate and assumed that the real long-term growth rate is independent of the choice among low inflation rates.

⁵Although their emphasis is on monetary policy, they note the advantage of combining very easy monetary policy with fiscal expansion.

Their reasoning, in brief, is that deflation can imply high real interest rates even if the nominal interest rate is reduced to a near-zero level. Such high real rates would push the economy deeper into recession and cause an even faster decline of prices. They conclude that to avoid this vicious downward spiral, it is important to cut interest rates sharply while inflation is still positive if there is a danger that it may evolve into deflation.

They argue, in effect, that with low interest rates, low inflation and weak demand, the risks to the economy are asymmetric. If demand continues to decline, prices might start falling and produce a condition that an expansionary monetary policy cannot correct. In contrast, if the expansionary monetary policy turns out to have been unnecessary, the result will be a higher rate of inflation which can later be brought down by a tighter monetary policy.

This is however an unnecessarily risky strategy. The “hyperexpansive” monetary policy might cause an asset price bubble in securities and real estate markets or an excessive decline of the exchange rate as well as a more rapid increase in the prices of goods and services.⁶ The adverse effect when the asset price bubble later collapses or the exchange rate rises might be severely destabilizing. An excessively easy monetary policy is a dangerous tool.

It is also an unnecessary tool. Monetary policy may be effective even when the short-term interest rate is close to zero and fiscal policy can be effective even when monetary policy cannot be. Even when the price level is falling, the lower bound on nominal interest rates may not mean that monetary policy is ineffective. Although there is a lower bound on interest rates, implying a positive real interest rate, a rapid increase in the base money supply achieved by

⁶Ahearne et. al. (2002) acknowledge that excessively easy money may cause an overshooting of asset prices and exchange rates.

buying long term assets and foreign exchange might still be able to stimulate the economy. However, lower long term nominal rates may still leave positive real rates if deflation is rapid and a sharp decline in the exchange rate might create destabilizing adverse “beggar thy neighbor” effects on other economies.

In this situation, discretionary fiscal policy could be used either to prevent the economy from slipping into deflation or, if deflation occurs, to bring it back to price stability .

Since I began by pointing out the difficulties of using discretionary fiscal policy under normal circumstances, let me comment now on why it might be effective in the deflationary situation of the type that Japan is now experiencing. First, the dampening effect of increased short-term interest rates caused by an induced rise in money demand can obviously be offset in this case by a monetary policy that holds short rates constant. Moreover, the problem of lags and uncertainty is not relevant when we are considering a long-term situation of depressed demand like that in Japan rather than the traditional business cycle downturn that lasts less than a year.

Fiscal Expansion Without Budget Deficits

The final common objection to using discretionary fiscal policy is the possible contractionary effect on current demand of an increase in the current or expected future deficit. It is important therefore to emphasize that an expansionary fiscal policy need not involve a rise in the full employment deficit if its expansionary impact is achieved by increasing the private incentive to spend. A fiscal policy can be expansionary if it has a positive substitution effect even if there is no income effect. Indeed, a fiscal incentive that succeeds in increasing economic

activity can actually reduce current and future budget deficits.

To be specific, I will now give two kinds of examples of discretionary targeted fiscal incentives that I believe could stimulate economic activity in a situation characterized by low demand, low inflation, and low interest rates.

Offsetting the Effect of Low Interest and Inflation Rates on Business Investment

Because tax rules do not distinguish between nominal and real interest rates, a fall in inflation with a constant real interest rate causes the real net-of-tax interest rate to rise. Even when inflation is zero or positive, a decline in inflation rate causes a higher real net-of-tax interest rate. One way to offset this and maintain the same incentive to invest is to modify the depreciation rules or the investment tax credit.

More formally, the real interest rate (r_n) is related to the nominal interest rate (i), the tax rate (t) and the rate of inflation (π) by $r_n = (1-t) i - \pi$. A change in inflation that does not alter the real interest rate ($r = i - \pi$) implies $di/d\pi = 1$ and therefore $d r_n / d \pi = -t$. Consider for example the implication if the real interest rate is 4 percent and the relevant tax rate is the corporate rate of $t = 0.35$. If the inflation rate is 4 percent, the nominal interest rate is 8 percent and the real net-of-tax interest rate is 1.2 percent [$0.65(0.08) - 0.04 = 0.012$]. If the inflation rate drops to zero, the nominal interest rate drops to 4 percent but the real net-of-tax interest rate more than doubles, going from 1.2 percent to 2.6 percent [$0.65 (.04) = 0.026$].

The incentive effect on business investment of the decline in inflation is of course more complicated because the fall in inflation also increases the present value of the nominal depreciation allowances.⁷ This offsetting effect is more important for some types of assets than

⁷See for example the discussion in Feldstein (1999).

for others, depending on the life of the asset and the depreciation rules. In the extreme, inventory investment (for a firm that uses last-in-first-out inventory accounting) is depressed by lower inflation because there is no offsetting change in the value of depreciation to balance the rise in the real net-of-tax interest rate.

If the net effect of the lower inflation rate is to reduce the overall incentive for business investment, the depressing effect on aggregate demand can be offset by a suitable investment tax credit. This is true even if the inflation rate is negative.

Stimulating Demand by Households and Businesses in Japan

Japan has now experienced a decade of stagnation with growth rates that are far less than Japan's potential and with several years of declining prices. Although the short term interest rate is essentially zero, the real rate is positive and could rise if the rate of deflation increases. The large existing budget deficit (a primary deficit of about 5 percent of GDP) and the excessive national debt (a national debt that exceeds 140 percent of GDP) make additional fiscal deficits potentially counterproductive. In this context, I have previously discussed two targeted fiscal policies that could increase aggregate demand without increasing the size of the budget deficit (Feldstein, 2001).

The first option would increase consumer spending. The government of Japan has said for some time that it wants to reduce its reliance on the income tax and increase its reliance on its value added tax. The Japanese government could announce that it will raise the current 5 percent value added tax by 1 percent per quarter and simultaneously reduce the income tax rates to keep revenue unchanged, continuing this for several years until the VAT reaches 20 percent. This revenue neutral policy would imply consumer prices rising at the rate of four percent a year.

This tax-induced inflation would give households an incentive to spend sooner rather than waiting until prices are substantially higher. And yet it would not change the size of the structural budget deficit.

The second such revenue neutral targeted incentive policy could encourage business investment by a Japanese government announcement that it was instituting a large investment tax credit – say 30 percent – paid for by an increase in the corporate income tax and that the investment tax credit rate would decline by 5 percentage points a year until it was eliminated (with corresponding revenue neutral reductions in the corporate tax rate.) Companies, like the consumers in the previous example, would have a substantial incentive to spend sooner before the net price of investment goods rises. A similar declining tax credit could be applied to investment in business structures and residential housing.

In summary, an expansionary fiscal policy based on a revenue neutral structural incentive may be more productive and less risky than an excessively easy monetary policy as a way of dealing with a deflationary situation or one that could become deflationary.

This possibility of using discretionary fiscal policy in any country assumes of course that a political agreement can be achieved for legislative action in a timely enough fashion. If partisan conflict prevents this, the central bank would have to weigh the consequences of a potentially excessive monetary easing – including the consequences for security and real estate markets and for the exchange rate – against the risks of deflation.

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